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Self-Rental Tax Delimmas – Are you in Danger?

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What is a Self-Rental?



- The property owner materially participates in the entity renting the property
 - Income reclassified as non-passive
 - Losses remain passive
 - Credits remain passive
 - Activities remain passive





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Introduction – Tax Reform Act 1986

- Creation of IRC §469
 - §469(a) - Passive losses no longer deductible
 - §469(b) – Losses carried over to future years



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Tax Reform Act 1986



- §469(c) - Passive Activities Defined
 - Any Activity Lacking Material Participation
 - Any Rental Activity



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Tax Reform Act 1986



- §469(c)(6) – Connected to a Trade or Business
- §469(h) – Material Participation Defined
- §469(l) – IRS gets to write the rules - Legislative Regulations Authorized



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Code §482



- Allocation of income and deductions among taxpayers
 - In any case of two or more organizations..... owned or controlled directly or indirectly by the same interests,



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Code §482



- Allocation of income and deductions among taxpayers
 - The Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses.



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The Self Rental Rule



- Treasury Regulation §1.469-2(f)(6)
 - Property rented to a nonpassive activity. An amount of the taxpayer's gross rental activity income for the taxable year... is treated as not from a passive activity ...



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The Self Rental Rule



continued...

- if the property –
 - (i) Is rented for use in a trade or business activity
 - in which the taxpayer materially participates
 - §1.469–5T, yes still temporary



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Review of Concepts



- Self-Rental Rule – If the shoe fits, wear it
 - Material Participation
 - Legislative vs. Interpretive Regulations
 - Item of Property



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Review of Concepts



- Self-Rental Rule – If the shoe fits, wear it (yes, there's more)
 - Non-passive income is a separate type
 - Re-characterizations / Allocations



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Tax Risk #1



- Income from self-rentals cannot be orchestrated to be offset by net losses from other passive activities



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Tax Risk #2



- The netting of profits and losses from self-rentals is not allowed



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Tax Risk #3



- Income in excess of market rents from self-rentals can be re-characterized as dividend distribution income
- What about less than fair market rent?



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Tax Risk #4



- The self-rental rule still applies even if....
 - owner does not have any ownership in the leasing entity
 - rule is triggered if the owner is a “material participant” in the activities of the business



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Tax Risk #5



- Limits passive activity credits
- The self-rental rule only re-characterizes the income as non-passive



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Tax Risk #6



- For purposes of the earned income credit, nonpassive self-rental income remains disqualifying investment income



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Tax Risk #7



- Self-rental income is not portfolio income
 - not available as a source of investment income
 - no deduction of investment interest expense on Form 4952



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Tax Risk #8



- If an S-Corporation pays rent to an employee for the employee's home office, the activity is classified as a self-rental under the rule



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Risk Conclusion



- The self-rental rule is constitutional, was properly established and accurately reflects the legislative intent of Congress.



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Risk Conclusion



- The self-rental rule applies only to the income from an item of property and not to a loss and not to the activity itself.



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Risk Conclusion



- The reclassification of the self-rental income does not reclassify credits generated by the activity and is not applicable to other sections of the tax code.



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